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REAL ESTATE

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OUTLOOK

A Monthly Forecast for the Economy and Real Estate

FORECAST SUMMARY

- The annual rate of real GNP growth in the first quarter of 1988 was revised up to 3.9 percent from the preliminary estimate of 2.3 percent. The bulk of the revision came as a result of larger than expected gains in exports. The preliminary GNP report had to rely on incomplete trade data for the month of March. This faster rate of real GNP growth raises concerns over the prospect for accelerating rates of inflation in coming months. The forecast for GNP growth in 1988 has been revised upward to a 3.6 percent rate, measured on a year-over-year basis.
- Accelerating operating rates at U.S. factories in the face of rising domestic and foreign demand, increases in both new and unfilled orders for durable goods, and higher import prices are at the center of the debate about whether inflation will accelerate. Nonpetroleum merchandise import prices rose at an annual rate of 9.6 percent in the first quarter.
- Not all of the news on inflation confirms an accelerating trend. Wages are rising at a surprisingly modest rate so far in 1988. In addition, the overall pace of consumer price inflation reached an annual rate of only 3.4 percent in the first quarter. In 1988, consumer prices are expected to increase at an annual rate of 4.1 percent, measured on a year-over-year basis.
- The recent rise in long-term interest rates has resulted from the concern over faster inflation. Currently, interest rates on fixed-rate mortgages are averaging 10.5 percent, and are expected to move higher during the summer. Mortgage rates could rise past the 11.0 percent level by late this fall. For all of 1988, the secondary mortgage market rate on FHA insured mortgages is expected to average 10.5 percent.
- Existing single-family home sales are currently enjoying a much stronger springtime buying season than previously expected. Existing single-family home sales rose to a seasonally adjusted annual rate of 3.48 million units, 4.5 percent faster than the March annual rate of 3.33 million units. This was the fastest monthly advance in the annual rate since November 1986. The pace of home sales is expected to eventually slow as a result of the rise in mortgage interest rates. Existing single-family home sales are expected to total 3.34 million units in 1988.

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BOGSAT

Economic Commentary

by
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National policy during the Carter Administration (has it really been *twelve* years?) was often developed through the process of BOGSAT -- a bunch of guys sitting around talking. Sometimes it seems that BOGSAT is now the mode for economic policy: we are pushed and tugged not by sound analysis, but rather by rumor and opinion molded by people who talk mainly with each other.

Take a look at reality. The gross national product for the first quarter expanded at nearly a four percent rate, adjusted for inflation. The root of this growth was a significant expansion of exports, a trend that is now nearly eighteen months old. More importantly, business investment was also a large part of this growth picture. While it's true that inventory pile-up was unusually large, we are still seeing an investment process born of an optimism characterized by a large drop in business failures during the first quarter. Manufacturing productivity is up and, largely as a response to increased demand for exports, so is capacity utilization. Unemployment is at a ten-year low. Sounds like a prosperous economy, doesn't it?

Now, let's examine policy perception. Do our opinion leaders -- the Congress, the press -- see this same pattern and use it as the basis of policy. In the words of John Belushi, NO-O-O-O-O-O! Policy making appears based on an entirely different set of facts, a world where an inflation plague is about to break out, manufacturing has been crushed by a growing service sector and where American goods are so uncompetitive that enormous trade barriers must be thrown up. From these "facts" stem financial market behavior that pushes interest rates up and legislation that could initiate destructive trade wars. This is BOGSAT at its finest. When bond traders talk only to bond traders and Congress listens only to those whose opinions match its own preconceptions, sound economic policy is the victim.

Of course, there is the danger of being too much the Pollyanna. Given the fall in the dollar and the increasing pace of export production, inflation could be a problem. And there is little doubt that the CPI in 1988 will rise more than it did in 1987, while interest rates will drift up through the rest of this year. But three factors ought to keep the economy well within bounds. First, the real strengths described above are a substantial brake on any kind of speculative excess. Second, the current Federal Reserve Board appears to be committed to making small changes quickly to blunt the build-up of inflationary pressures. Finally, the openness of the U.S. economy provides sufficient safety valves to calm excessive price movements.

The net here is that the economy is fundamentally sound. We seem, by some fortuitous confluence of events, to have reinvented the prosperity of the early 1960's. There is at least another year of steam in this expansion. Part of the problem with the dichotomy between reality and policy perception, however, is that we've changed since then. We are more open to the rest of the world and our economy is more service-oriented, and both of these things are frightening to those who can't (or won't) deal with change.

In "The Cherry Orchard," a (very bad) play by Anton Chekhov, the merchant Yermolay Andreyevich Lopakhin buys at auction the cherry orchard which symbolizes the lives and traditions of a dying aristocratic family. He transforms the beloved orchard into summer home lots, destroying the orchard so that (in his words), "it may once more be fruitful." This is an economy which is fruitful, but in a transformed way. It's a change that has been good, but for some, has been hard to accommodate.

Outlook for the Economy and Real Estate

THE ECONOMIC OUTLOOK

The economy appears to be expanding at a rate much faster than expected in the wake of the stock market crash. The first quarter annual rate of real GNP growth was revised up to an annual rate of 3.9 percent, much higher than the original estimate of 2.3 percent. A modest upward revision had been expected, but not the near doubling of the estimate. This has raised the risk of inflation from an overheating economy. While the aggregate inflation measures are not yet showing these accelerating rates of inflation, some of the underlyiung characteristics of this recent surge in growth suggest faster price increases may be in store. Accelerating operating rates at U.S. factories in the face of rising domestic and foreign demand, shortages in the supply of needed component parts, and higher prices on nonpetroleum merchandise imports are but a few of the emerging trends. The list only lacks a steady rise in wages as the flashpoint for a renewed wage price spiral. From last month, we have revised upward our estimate of real GNP growth for the current quarter from 2.5 percent to 2.9 percent which has also led to upward adjustments in the inflation path, which is expected to average 4.1 percent in 1988 on a year-over-year basis. The forecast has been extended to 1990 with this forecast.

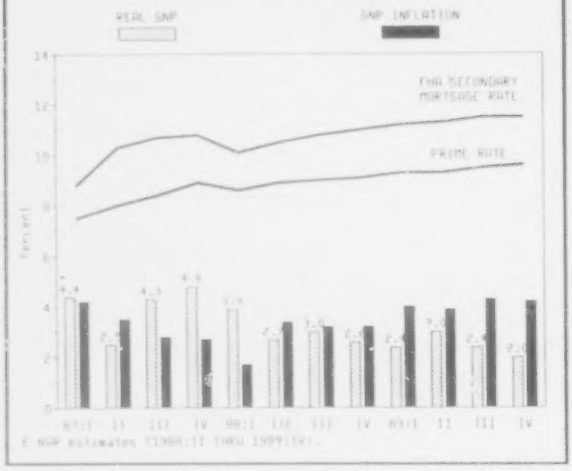
Exports Are Booming

The bulk of the revision in the annual rate of first quarter real GNP growth occurred as a result of huge gains in exports. The preliminary GNP report had relied on incomplete trade data for the month of March. But a full quarter's reporting on the trade data has confirmed the continued surge in U.S. exports. However, much of this external demand for U.S. goods has put pressure on U.S. manufacturers to expand capacity. The response is clear: both the preliminary and revised GNP reports confirm that U.S. manufacturers are re-tooling at a more rapid rate. The steady contribution of the U.S. consumer is another important feature of both GNP reports. This is a positive trend to the extent that U.S. consumers continue to adjust their preferences away from imported goods and in favor of U.S. goods.

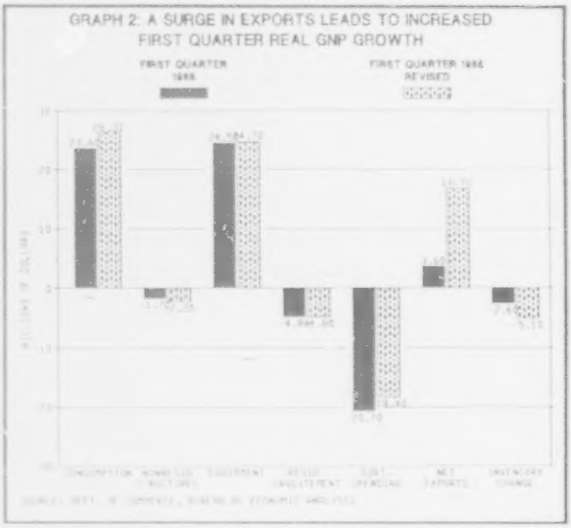
Durable Goods Orders

The news on durable goods orders has also been very good, and again, possibly a bit too good for the economy's short-term inflation prospects. At first glance, the nation's manufacturers of durable goods are in an enviable position: durable goods producers received orders at a rate of $116.3 billion in April, 0.8 percent higher than March, a month in which they rose even faster, by 0.9 percent. The frenzied pace of orders has helped drive the jobless rate at durable goods manufacturers down to 4.8 percent in April. However, all of this heating up could possibly lead to an overheating economy if plant and equipment re-tooling can not keep up with demand. Unfilled orders for durable goods have been rising at an increasing rate, further evidence that businesses are finding it difficult to expand capacity fast enough. The next development could possibly be a bursting of the protective bubble of modest wage settlements so far in the 1980's, which could be followed closely by a faster overall rate of price increases.

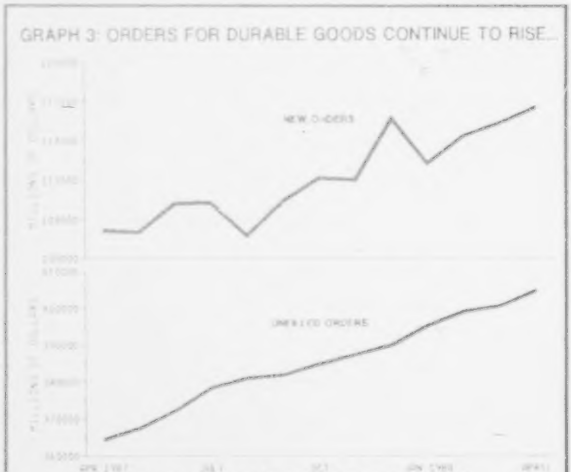
GRAPH 1: THE ECONOMIC OUTLOOK



GRAPH 2: A SURGE IN EXPORTS LEADS TO INCREASED FIRST QUARTER REAL GNP GROWTH



GRAPH 3: ORDERS FOR DURABLE GOODS CONTINUE TO RISE...



...MAKING IT HARDER TO GET THEM FILLED.

SOURCE: CURRENT INDUSTRIAL REPORTS

Inflation Heating Up?

The outlook for inflation, when thought of from the perspective of an overheating economy appears to be one of considerable risks on the upside. Indeed, the arguments commonly used to advance this point are rather convincing. First, domestic producers could be forced to raise prices on their goods in order to keep up with price increases they are encountering on intermediate goods purchased from other capacity-constrained producers. Further, many U.S. manufacturers are bracing for higher wage settlements in 1988 after achieving several years of modest wage advances as part of efforts to improve efficiency. Abroad, foreign producers are showing signs of crying "uncle" and are finally caving in to the lower dollar by raising their prices to American consumers. Evidence of this overdue development showed up in the latest report on import prices. In the first quarter of 1988, prices on non-petroleum merchandise imports rose 9.6 percent. Not only was the magnitude of the price rise disturbing, but the fact that the number excluded the more volatile petroleum products has hammered home the point.

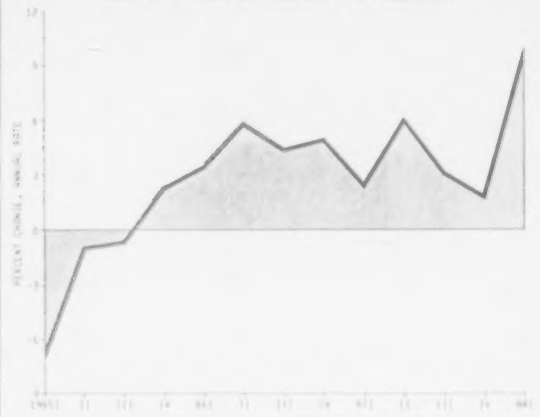
Maybe Not

But the potential for accelerating rates of inflation is tempered by the widespread concern that an economic slowdown is inevitable. Those that share this view say that the soft spots in the economy are beginning to surface, and they include an overextended consumer and a housing industry emerging from two years of record growth (during which more than 7 million existing homes were sold, and nearly 2.0 million new homes were started, in 1986 and 1987). The economy is presently experiencing a rise in interest rates that could dampen the prospects for continued growth later in the year. Also, the annual rate of growth in consumer prices as measured by the Consumer Price Index does not support the notion that the overall rate of price advances has begun to spiral upward. The first quarter's 3.4 percent annual rate of advance in consumer prices reinforces the view that prices are not yet accelerating.

MONETARY POLICY AND INTEREST RATES

The current monetary policy stance of the Federal Reserve Board appears to be one of tightening up in the face of heightened inflation fears. As the graph to the right shows, the yields on instruments of virtually all maturities have risen steadily in the last few months. Hoping to quiet these inflation fears, the Fed has tightened its grip on the money supply and consequently nudged up short-term interest rates. This is evident from the widening gap between the yield curves at the short-term edge. The fact that the Fed has allowed interest rates to rise signals their comfort with the economy's present rate of growth, but not with the expected level of inflation. In the coming months, interest rates on all maturities are expected to rise, pushing the yield curve up even higher. If the Fed's efforts at reducing the fear of inflation are successful, then some flattening of the yield curve may occur.

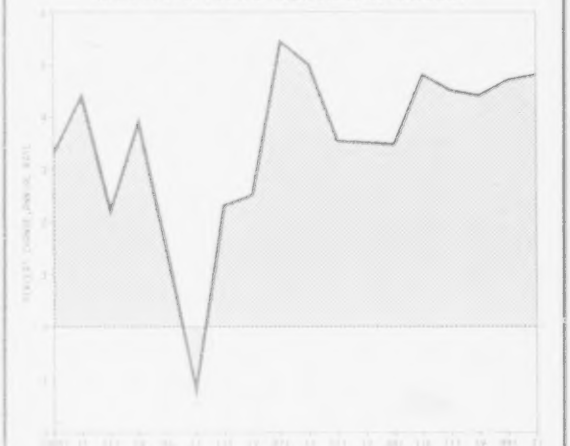
GRAPH 4: WILL RISING IMPORT PRICES...



MAKE INFLATION OUR NEWEST IMPORT?

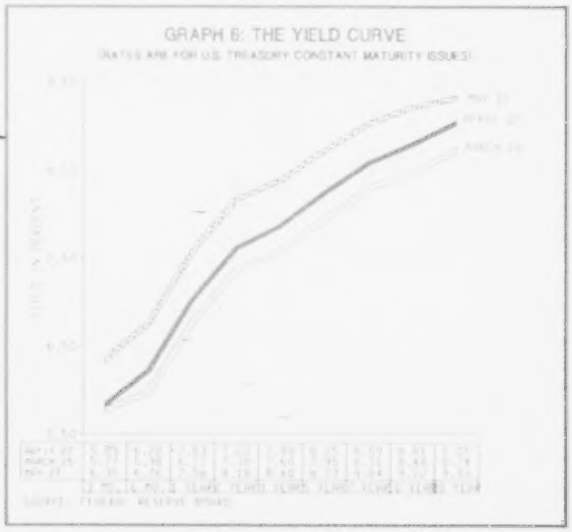
SOURCE: BUREAU OF ECONOMIC ANALYSIS

GRAPH 5: CPI INCREASES REMAIN MODEST



GRAPH 6: THE YIELD CURVE

(RATES ARE FOR U.S. TREASURY CONSTANT MATURITY ISSUES)

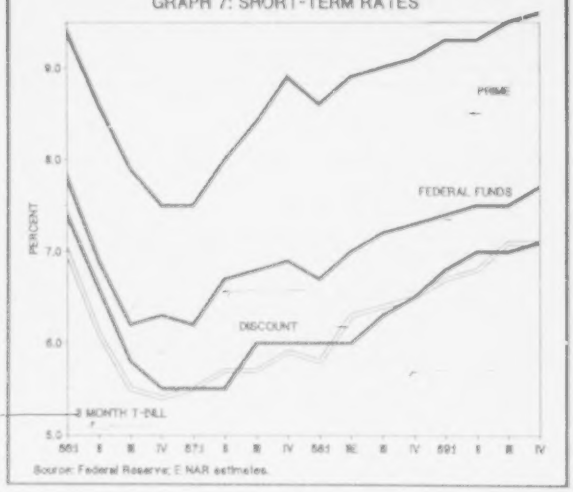


Short and Long-Term Rates Headed Higher

The signs of a resurgence of economic growth from explosive export demand has helped raise interest rates in recent weeks. Financial market players have eyed the faster real GNP growth and falling unemployment rate with increasing concern over what they both might mean for faster rates of inflation. The Fed has already taken action to discourage these inflation fears on at least two occasions so far in 1988. First, after watching the federal funds rate drift lower following the stock market crash in October, the Fed acted in earyl April to move the rate back above the 6.75 percent mark. The second action came on the eve of the quarterly refinancing in early May, when the Fed nudged the rate just above 7 percent. Already, the Fed appears to have tightened a third time, this in respone to the stronger GNP report. Since that report was released, the federal funds rate has been trading at about 7.375 percent. Usually, the federal funds rate and the more visible discount rate move together, with but small gaps between the two rates. For the moment, the Fed seems to be reserving an increase in the discount rate; perhaps as a means of reassuring foreign investors holding dollar-denominated assets in the event of another slide in the dollar. As a result, an unusually large gap has opened between the federal funds rate and the discount rate. This could bring criticism that the Fed is actually pursuing a looser policy than the federal funds rate implies, and that it is subsidizing the borrowing costs of U.S. banks through the lower discount rate. Therefore, the current forecast projects the Fed raising the discount rate by mid-July.

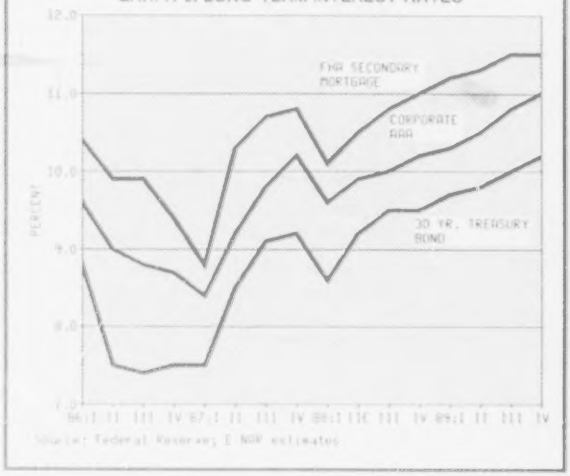
The Fed's actions notwithstanding, expectations of faster inflation have already brought increases in long-term interest rates. The current forecast projects this upward trend to continue through the rest of 1988. The secondary market yield on FHA guaranteed mortgages is expected to average 10.5 percent in the current quarter, rising steadily during the summer to more than 10.75 percent, to reach an annual average of 10.5 percent in 1988.

GRAPH 7: SHORT-TERM RATES



Source: Federal Reserve; E NAR estimates.

GRAPH 8: LONG-TERM INTEREST RATES



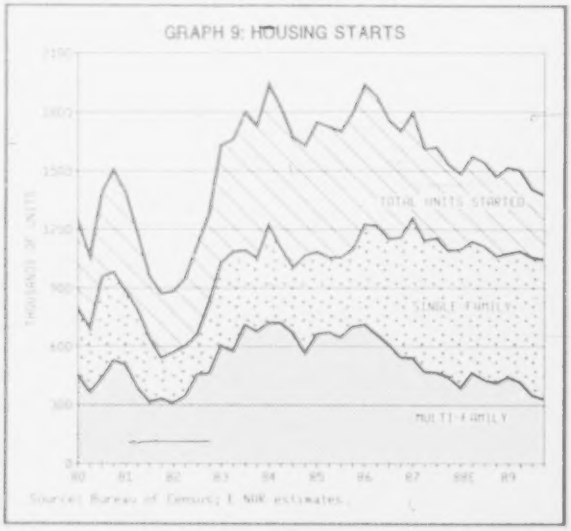
Source: Federal Reserve; E NAR estimates

REAL ESTATE MARKETS

Housing Starts

Privately owned housing units were started at a seasonally adjusted annual rate of 1.561 million units in April, marginally faster than the March annual rate of 1.554 million units. The rise in the April rate was the third consecutive monthly advance in the total starts rate. Single-family units were started at an annual rate of 1.095 million units in April, almost 7 percent slower than the March annual rate of 1.176 million units. The rise in the overall starts rate was based on a 28.7 percent advance in the annual rate of multi-family structures with five or more units. These structures were started at an annual rate of 408 thousand units in April. Multi-familly structures with 2-4 units were started in April at an annual rate of 58 thousand units, off 5 percent from the March pace of 61 thousand units. These starts figures demonstrate that considerable strength remains in the housing industry. However, the softness in single-family starts during April could be a sign that builders are becoming a bit more skeptical of the consumer's ability to continue to support the present level of demand.

GRAPH 9: HOUSING STARTS



Source: Bureau of Census; E NAR estimates.

New Home Sales

Mimicking the three consecutive monthly advances in total housing starts, new single-family home sales rose in April for the third month to an annual rate of 679 thousand units. The April rate was almost 4 percent faster than the March annual rate of 653 thousand units. However, the April annual rate was 6.7 percent below the annual rate of one year ago. The pace of new home sales picked up in each of the four regions monitored: Northeast up 2.8 percent; Midwest up 5.9 percent; South up 2.9 percent; West up 5.5 percent. The annual rate of new home sales is expected to slow somewhat in coming months, reaching an annual total for 1988 of about 642 thousand units, some 4 percent below the 1987 total of 671 thousand units. In 1989, sales of new single-family homes are expected to weaken further to 622 thousand units due to increases in mortgage interest rates.

Existing Home Sales

The pace of existing single-family home sales quickened in April, rising to a seasonally adjusted annual rate of 3.48 million units, 4.5 percent faster than the March annual rate of 3.33 million units. This advance represented the fastest monthly advance in the annual rate since November 1986. Apparently, two factors shared credit for the rapid advance. First, relatively low interest rates in the opening days of the month encouraged homebuyers to make purchases. Later in the month, rising interest rates brought many potential homebuyers off the fence and into the resale market. The fact that springtime homebuying has been very strong in recent years explains why the surprisingly strong April 1988 rate was still below the April 1987 annual rate of 3.59 million units.

On a regional basis, the annual rate of existing single-family home sales advanced in every region but the West, where the rate fell slightly. The regional changes were as follows: Northeast up 6.2 percent to 690,000; the South up 5.7 percent to 1.3 million; the Midwest up 2.3 percent to 900,000; the West down 1.8 percent to 560,000.

This broad base of existing home sales strength indicates that sales rates are likely to remain strong through the remainder of the springtime buying season. However, the expected upward trend in mortgage interest rates will dampen home sales rates later this summer. Existing single-family home sales are expected to reach 3.34 million units in 1988.

Home Prices

The median existing single-family home price fell $200 from March to April to $87,700, which is 2 percent above the $86,000 year-ago price. The slight decline in prices is part of an overall leveling off in home prices this Spring. New home price appreciation has also slowed in recent months. In the remainder of 1988, both new and existing home prices are expected to increase only modestly, but keeping pace with the rate of overall price inflation

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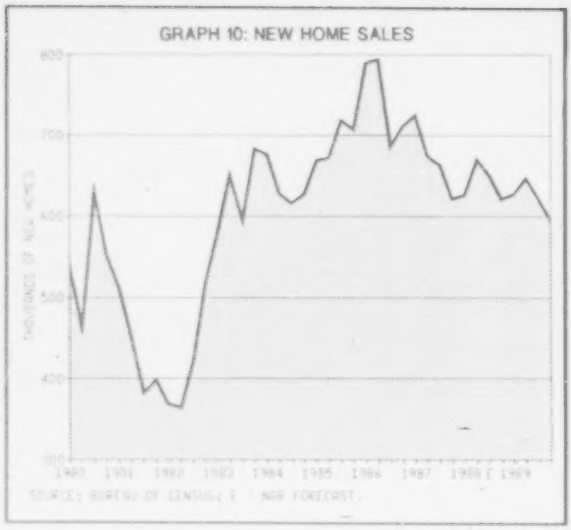

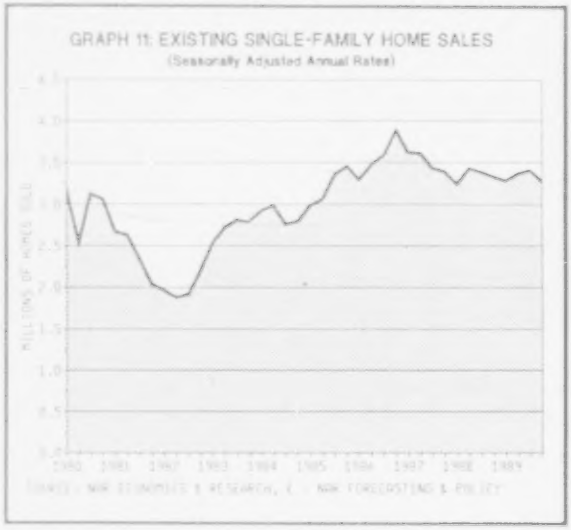

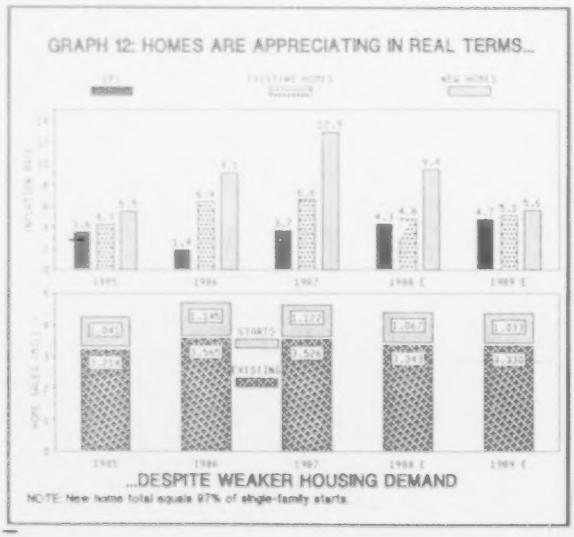
GRAPH 12: HOMES ARE APPRECIATING IN REAL TERMS...
...DESPITE WEAKER HOUSING DEMAND
NOTE: New home total equals 97% of single-family starts.

	QUARTERS							YEARS				
	Actual		Forecast					Actual		Forecast		
	1987.4	1988.1	1988.2	1988.3	1988.4	1989.1	1989.2	1986	1987	1988	1989	1990
AGGREGATE ECONOMY												
Gross National Product (billions of dollars)	4607	4669	4742	4815	4886	4962	5046	4235	4486	4776	5080	5398
% Change	7.6	5.4	6.4	6.4	5.9	6.4	7.0	5.6	6.0	6.4	6.3	6.2
% Change (w/out inflation)	4.8	3.9	2.9	3.0	2.4	2.4	3.0	2.9	2.9	3.6	2.6	1.9
Consumer Price Inflation (CPI)	3.6	3.4	4.6	4.5	4.4	4.7	4.8	1.9	3.7	4.1	4.6	5.1
GNP Inflation (GNP Deflator)	2.7	1.7	3.4	3.2	3.2	4.0	3.9	2.6	3.0	2.7	3.7	4.3
Unemployment Rate - Civilian	5.9	5.7	5.4	5.3	5.2	5.2	5.1	7.0	6.2	5.4	5.2	5.5
Civilian Employment-Household Basis (millions)	113.5	114.2	115.1	115.7	116.2	117.1	117.5	109.6	112.4	115.3	117.3	118.5
Percent change	2.3	2.5	3.1	2.1	2.3	2.5	2.0	2.3	2.6	2.4	1.7	1.0
Index of Industrial Production	133.0	139.6	141.3	143.1	143.8	144.2	145.4	125.1	129.8	136.6	139.6	140.9
Manufacturing Capacity Utilization	82.2	82.6	83.1	83.5	83.6	83.6	83.7	79.7	81.0	83.2	83.7	83.1
Domestic Auto Sales	6.7	7.6	7.2	6.9	7.0	7.0	7.0	8.2	7.1	7.2	7.1	6.9
Federal Tax Receipts (NIPA) as % of GNP	20.4	20.1	20.5	20.2	20.3	20.4	20.4	19.5	20.4	20.4	20.4	21.0
Federal Expenditures (NIPA) as % of GNP	24.0	23.9	23.6	23.7	23.8	23.7	23.6	24.4	23.8	23.7	23.6	23.5
Deficit (NIPA)	-165.9	-175.0	-156.6	-167.0	-171.3	-164.4	-158.5	-204.7	-152.8	-158.9	-163.6	-142.9
as % of GNP	-3.6	-3.8	-3.3	-3.4	-3.5	-3.3	-3.1	-4.8	-3.4	-3.3	-3.2	-2.6
REAL ESTATE MARKETS												
HOME SALES												
Total Single-family Home Sales (thousands, single-family resales plus 97 percent of single-family starts)	4447	4305	4531	4459	4352	4322	4418	4717	4649	4388	4342	4208
Percent change -- year ago	-12.2	-10.3	-3.5	-1.6	-2.1	.4	-2.4	10.9	-1.4	-5.6	-1.0	-3.1
Existing Single-family Home Sales (1000)	3390	3240	3430	3380	3325	3280	3365	3565	3526	3343	3330	3236
Percent change -- year ago	-12.8	-10.4	-4.9	-1.7	-1.9	1.2	-1.8	10.9	-1.1	-5.1	-0.4	-2.8
Housing Starts (thousands)	1533	1485	1572	1542	1470	1517	1503	1805	1634	1517	1450	1362
Percent change -- year ago	-10.7	-16.5	-2.1	-4.7	-4.1	2.2	-4.4	3.6	-9.8	-7.2	-4.4	-6.1
Single-Family Units	1090	1098	1136	1113	1059	1075	1086	1179	1157	1101	1065	1024
Percent change -- year ago	-6.2	-11.8	-0.1	-3.6	-2.8	-2.1	-4.4	10.0	-1.9	-4.84	-3.27	-3.85
Multi-Family Units	443	387	463	429	411	442	417	631	477	416	385	338
2-4 Family Units	56	58	65	64	61	66	62	84	66	62	57	50
Percent change -- year ago	-35.9	-26.6	-9.7	16.4	8.9	13.8	-4.6	-10.1	-21.2	-6.1	-8.1	-12.3
5+ Family Units	387	329	371	365	350	376	355	542	412	354	328	289
Percent change -- year ago	-17.1	-27.5	-6.3	-10.8	-9.33	14.29	-4.31	-5.9	-25.1	-14.08	-7.34	-11.89
New Single-family Home Sales (thousands)	621	626	670	651	621	627	647	750	671	642	622	534
Percent change -- year ago	-12.6	-11.9	-0.6	-3.4	0.0	0.2	-3.4	9.0	-10.1	-4.3	-3.1	-14.1
Mobile Homes Shipped (thousands)	232	207	212	199	194	193	191	249	233	203	187	174
HOME PRICES												
Existing Home Prices - Median ($1000)	85.0	87.8	88.0	90.6	92.5	93.4	94.0	80.3	85.6	89.7	94.3	99.3
Percent change -- year ago	6.0	3.2	5.4	6.1	9.5	7.6	7.7	6.4	6.6	4.8	5.1	5.3
New Home Prices - Median ($1000)	111.8	114.3	111.5	114.2	115.3	116.0	118.4	92.0	104.0	113.8	120.2	125.0
Percent change -- year ago	19.5	17.4	7.7	7.0	3.7	2.2	4.7	9.1	12.9	9.4	5.6	4.0
FINANCIAL MARKETS												
Long-Term Interest Rates												
30-yr FRM (FHA Secondary)	10.8	10.1	10.5	10.8	11.0	11.2	11.3	9.9	10.2	10.5	11.0	11.5
1-year ARM (without buydown)	8.2	7.5	7.3	7.3	7.5	7.7	8.0	7.9	8.2	7.4	8.0	8.5
Corporate AAA Bond Rate	10.2	9.6	9.9	10.0	10.2	10.3	10.5	9.0	9.4	9.9	10.7	11.0
Government Bond Rate	9.2	8.6	9.2	9.5	9.5	9.7	9.8	7.8	8.6	9.2	9.9	10.2
Short-Term Interest Rates												
Federal Funds Rate	6.9	6.7	7.1	7.2	7.3	7.3	7.5	6.8	6.7	7.0	7.5	7.8
3-month T-Bill Rate	5.9	5.8	6.3	6.4	6.5	6.7	6.8	6.0	5.8	6.2	6.9	7.1
Prime Rate	8.9	8.6	8.9	9.0	9.1	9.3	9.3	9.2	8.6	8.9	9.5	9.8
Discount Rate	6.0	6.0	6.0	6.3	6.5	6.8	7.0	9.2	8.6	6.2	7.0	7.3
Value of the U.S. Dollar (Trade-Weighted Avg.)	92.3	90.0	88.8	88.4	87.7	86.3	85.1	112.3	96.9	87.5	82.7	80.3
Percent change -- year ago	-13.8	-9.9	-8.4	-10.4	-5.0	-4.1	-4.2	-21.6	-13.6	-9.7	-5.5	-3.0

Source: Forecast produced using Laurence H. Meyer and Associates' model of the U.S. economy.
Assumptions and simulations by Dr. John Tuccillo, Dr. Frederick Flick and Sean Burns.

Secondary Market Outlook

by
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A proposal to deregulate the Ginnie Mae servicing fee could have a profound effect on the cost and availability of FHA and VA financing for homebuyers.

Ginnie Mae, the Government National Mortgage Association, is a federal agency that guarantees timely payment of principal and interest on pools of FHA, VA and FmHA Loans backed by securities issued by approved lenders. These "Ginnie Maes" have become the cornerstone of the mortgage-backed securities market, providing liquidity and safety to the investor, and paving the way for securitization by Fannie Mae, Freddie Mac and private lenders.

The Ginnie Mae program has been one of the most successful government efforts in mortgage finance, as well as one of the most profitable. Over $476 billion of Ginnie Mae securities have been issued since the program began in 1970, and, as of the end of Fiscal Year 1987, Ginnie Mae had paid out only $22.2 million in claims against its guarantee.

A proposal by the Administration to permit flexibility in setting the servicing fee retained by the Ginnie Mae issuer is viewed with concern by mortgage lenders, who fear its adoption could threaten the viability of the Ginnie Mae and even FHA programs.

On its face, the proposal seems attractive. Under the most popular Ginnie Mae program, the mortgage banker/issuer pools loans of identical interest rates, and is required to issue a security with a face interest rate that is 50 basis points (.50%) less that the interest rate on the loans in the pool. For example, 10% FHA loans would be pooled into a 9.50% Ginnie Mae security.

Investors in the security receive their principal payments each month, as borrowers repay their loans, and interest at the face rate of the security. The .50% difference between the rate the borrower pays and the rate the investor receives is divided between the issuer and Ginnie Mae. Ginnie Mae receives 6 basis points as a guarantee fee. The remaining 44 basis points is retained by the issuer as compensation for "servicing" the loan-- collecting payments from borrowers, reporting to Ginnie Mae, remitting proper payment to investors, collecting delinquent payments and where necessary, handling loans to foreclosure.

The amount of the servicing fee is critical, because it is the primary source of profit for lenders who sell their loans in the secondary market.

Under the proposed change, the lender/issuer would be permitted to set its servicing fee below the currently required 44 basis points, down to some minimum required level. This flexibility would allow the issuer to retain a lower servicing fee and assign a higher interest rate to its Ginnie Mae.

The effect of a higher security interest rate is a higher price to the issuer when the Ginnie Mae is sold--a 9.75% security, for example, is worth more than a 9.50% security.

Thus, if the proposed change were adopted, a lender/issuer could increase the proceeds from the sale of a Ginnie Mae merely by reducing its servicing fee and raising the security interest rate. In effect. the lender would have traded future income (the higher servicing fee, which is paid each month on the outstanding principal balance of the loans in the pool) for more cash up front, at the time the security is sold.

This tradeoff, however, could result in a servicing fee inadequate to cover the costs of servicing and produce a profit. The issuer must still service the loans in the pool, which requires that it maintain servicing systems and personnel. Further, the servicer must remit principal and interest payments to investors whether or not the borrower has paid; the servicer is reimbursed either when the borrower catches up on the delinquent payment, or when the loan goes into foreclosure.

Reduced servicing compensation would reduce cash flow to the servicer available to meet remittance requirements, and could result in an unprofitable servicing operation, forcing cutbacks in payment collections and other loan administration activities. Curtailing such efforts often leads to higher delinquencies and foreclosures, which would increase costs to Ginnie Mae and FHA. Ultimately, these higher costs would be passed on to the borrower, who could find government mortgage programs too expensive relative to conventional loan sources.

The experience with Ginnie Mae's FHA multifamily security program is a telling case in point. The allowable servicing spread was low--only 10 basis points--and issuers could earn a much higher price on the security than if they were required to retain a higher servicing fee. The result was high delinquencies, because issuers could not afford to maintain appropriate levels of servicing personnel and facilities.

The designers of the original Ginnie Mae program recognized the dangers of inadequate servicing fees. The program was structured to provide a benefit to the lender/issuer, in the form of the Ginnie Mae guarantee and its attendant benefits of safety and marketability. In return, the lender is required to "earn" this value added over time, as the servicing fee is collected.

By providing the alternative of collecting more value up front, in the form of a higher price for the Ginnie Mae security, the proposal gives lenders a strong financial incentive to "cash out" in the short run, which could set the stage for deterioration in the servicing operation. The result could be significant damage to the Ginnie Mae program and the FHA, VA and FmHA programs it helps to finance.

New Tax Rules and Proposed Tax Laws Affecting Real Estate

Fifteen days before many Americans were rushing to their local Post Office to file their Federal Income Tax returns, the chairmen of two key House and Senate committees were making their own tax filing. These filings, however, were the legislative proposals to fix the tax law's clerical and drafting errors and to provide guidance to taxpayers and tax practitioners in understanding the Tax Reform Act of 1986 and the Omnibus Budget Reconciliation Act of 1987. Senate Finance Committee Chairman Lloyd Bensten and House Ways and Means Committee Chairman Dan Rostenkowski introduced the Technical Corrections Act (TCA) of 1988 into their respective houses of Congress on March 31, 1988.

THE CURRENT BILLS

The bills (H.R. 4333 and S. 2238) as introduced do not contain many revenue generating or losing provisions. Since these bills appear to be the only vehicles for legislative changes to the tax code this year, many additional proposals for changes to the existing tax code are likely to be considered in both houses. Legislation has already been introduced to extend many provisions of existing law due to expire at the end of 1988. The separate bills could be amended into the TCA.

REAL ESTATE PROVISIONS

Provisions which affect real estate that are currently included in TCA are:

- Replace the term "real estate broker" with "real estate reporting person" in rules requiring that real estate transactions be reported to the Internal Revenue Service.
- Provide that interest on mortgage refinancings undertaken after August 16, 1986 and which do not increase the amount of mortgage debt outstanding remain fully deductible.
- Extend the mortgage credit certificate program through the end of 1988. A drafting error in the Tax Reform Act of 1986 allowed this program to expire at the end of 1987.
- Classify income received from installment sales closed before January 1, 1987 as "passive" income.

POSSIBLE AMENDMENTS

Additionally, several other real estate-related measures may be added to the technical corrections bill. These include:

- Amendments to the passive activity loss rules to allow active real estate owners to deduct out-of-pocket expenses against any type of income not just passive income. A separate bill (H.R. 3224) which would allow for this treatment was introduced by Rep. J.J. Pickle. Rep. William M. Thomas introduced a related measure which would allow taxpayers involved in real estate to deduct losses from properties against income from real estate-related fees and commissions in addition to rental income.
- Revisions in the treatment of unrelated business income. One proposal discussed in the House Ways and Means Committee would consolidate the income of a tax-exempt parent with that of a taxable subsidiary. If most of the income was earned in the taxable subsidiary, then the entire amount of income would be subject to the unrelated business income tax (UBIT). Thus, the taxable income from a Multiple Listing Service would be combined with the non-taxable income of the local board (the tax-exempt parent). If the taxable share of the aggregate income is over 50 percent of the total amount, then all of the income of both the MLS and the local board will be taxed.
- Changes in the capital gains tax rate. For the taxable year 1988 and beyond, all realized capital gains are treated as ordinary income and taxed at ordinary income tax rates. A number of bills to ease the taxes due on capital gains have been introduced. Most of these proposals are viewed as "laying the groundwork" for future changes. Overall, the tax-writers in Congress are reluctant to make any significant changes in the tax code so soon after the passage of the Tax Reform Act of 1986.

THE FUTURE

The Ways and Means Committee is expected to consider TCA in early June with the Senate to begin consideration at a later date. As the members of the tax writing committees seek to include revenue-losing provisions into TCA, they are also seeking means to increase tax revenues to pay for these measures. By balancing revenue losing and revenue raising provisions within TCA, the bill will remain revenue-neutral and thus not change the federal budget deficit. Even with revenue-raising provisions, some Congressmen have projected the price tag of TCA to be in the $14 to $17 billion range. As additional costly measures are added to the bill, its chance of passage diminishes. On the House side, Chairman Rostenkowski has committed himself to passage of TCA this year but, in his words, "it ain't gonna be easy." James Gould, Chief Counsel of the Senate Finance Committee was quoted on the chances of passage during this legislative session as "less than 50-50."

THE CLOCK

The prospects for passage of TCA this year may be influenced by the number of days in which Congress will be in session. As of June 1 there were 64 legislative days left on the House calendar and 65 days left in the Senate. Both bodies of Congress will be out of session in July for the Presidential Conventions plus two weeks in August. Each House has scheduled adjournment for early October which will give all House members plus one third of the Senate time to campaign in their home districts before the November election.

The delays involved in the legislative process result in difficulties for taxpayers and their accountants. To help these individuals make business decisions which could be affected by the changes contained in TCA, some Congressmen have asked the IRS to apply the current rules as if TCA had been enacted. Internal Revenue Service Commissioner Lawrence B. Gibbs and Assistant Treasury Secretary O. Donaldson Chapoton have both stated that they lack the authority to enforce the tax code as if pending legislation were enacted. Therefore, any changes contained in the TCA will not apply to taxpayers unless the legislation is enacted.

PASSIVE ACTIVITY REGULATIONS

On February 19, 1988, the Treasury Department issued the long-awaited first set of temporary and proposed regulations on the passive activity loss limitation. The extensive regulations are as complex as was anticipated. Perhaps the most surprising aspect of the regulations is the extent to which the Treasury aggressively exercised its legislative rule-making authority under the Code to construct barricades on potentially misused declarations of income and expense. The regulations contain many rules which operate in asymmetrical fashion to benefit the treasury but not the taxpayer. Additionally, the regulations provide the definition of "rental activity," and of "material participation" which will be used by the IRS.

The Treasury Department's intent behind many of the rules that specifically affect rental real estate under section 469 of the Internal Revenue Code is to prevent real estate from being used as a "passive income generator" or "PIG." Under the definitions of section 469, the "passive activity loss" for the taxable year cannot be used to offset other types of income. The "passive activity loss" is defined as the excess of losses from passive activities over income from such activities. Under this section, a "passive activity" generally includes any trade or business in which the taxpayer does not materially participate and any rental activity. "Portfolio" income - generally interest and dividend income - is treated as not from a passive activity, and hence cannot be offset by passive losses. Similarly, "earned income" - wages, compensation, and the like - is treated as not from a passive activity. The disallowed passive activity loss may be carried forward indefinitely and deducted in subsequent years to the extent of passive income. Any losses not previously deducted may be deducted without regard to the passive loss limitation when the taxpayer makes a taxable disposition of the passive activity.

The application of phase-in rules permit a decreasing portion of the otherwise disallowed passive loss to be deductible until 1991 on passive activities owned before October 22, 1986. Taxpayers who are subject to the alternative minimum tax are effectively denied the benefit of the phase-in relief. Most significantly, Treasury has the authority to require net income from a passive activity to be treated as not from a passive activity.

Since a "passive activity" includes "any rental activity," the definition of "rental activity" is highly significant. Most real estate rented to commercial or residential tenants will clearly constitute a "rental activity." However, some activities - for example, the operation of a hotel or a residential nursing home - will require a careful analysis of the regulations before a determination can be made as to whether they are rental activities.

WHAT IS A RENTAL?

The code defines "rental activity" as "any activity where payments are principally for the use of tangible property." The regulations adopt this general definition, and also provide that the characterization by the parties of the arrangement as a lease or otherwise is irrelevant. Moreover, a rental activity may exist if the property is being held for rent even if no payment has yet been collected. As a result, any "pre-opening" expenses relating to rental property that somehow escape the grasp of the capitalization rules and the pre-opening expense doctrine will be governed by the passive loss limitation rules.

The regulations prescribe a set of relatively mechanical tests which, if met, will cause an activity in which tangible property is used by customers not to be treated as a rental activity. These tests generally focus on two factors: the average period of customer use and the level of services provided.

1. Customer Use of Seven Days or Less. The regulations provide that an activity involving the use of tangible property is not a rental activity if the average period of customer use is seven days or less. For this purpose, each period during which the customer has a continuous or recurring right to use the property is treated as a single period, regardless of whether the right stems from more than one lease arrangement or from renewal rights.

The legislative history of section 469 indicates that renting hotel rooms generally is not to be treated as a rental activity. The majority of hotels have an average room rental period of seven days or less.

2. Customer Use of Eight to 30 Days. If the average period of customer use is between eight and 30 days and "significant personal services" are provided, the activity will not be a rental activity.

This provision raises two questions. What are personal services, and what determines whether they are "significant?" "Personal services" include only services performed by individuals and do not include services provided in connection with the use of improved real property that are similar to services commonly provided in connections with long-term rentals of high-grade commercial or residential property (e.g., cleaning and maintenance of common areas, routine repairs, trash collection, and security). In addition, "personal services" do not include services performed in connection with improvements or repairs that extend the useful life of the property for a period substantially longer than the

average period of customer use. Finally, services necessary to permit the lawful use of the property are not taken into account.

In determining whether the personal services performed are "significant," the regulations state that all facts and circumstances are taken into account. Nevertheless, the critical consideration appears to be the value of the services provided compared to the amount charged to the customer for the use of the property. Examples in the regulations suggest that services with value greater than 50 percent of the amount charged to customers would be significant while services of less than 10 percent value would not be significant. This definition leaves a large gray area in this issue.

3. Customer Use Greater Than 30 Days. If the average period of customer use of the property exceeds 30 days, the activity will nevertheless not be a rental activity if "extraordinary personal services" are provided by or on behalf of the owner in connection with the use of the property. In order to be "personal," the services must be performed by individuals; in order to be "extraordinary," use of the property must be incidental to receipt of the services.

The regulations state that the extraordinary personal services standard "generally" is met with the respect to the use by patients of a hospital's boarding facilities and the use by students of a boarding school's boarding facilities. Whether nursing home and residential care facilities "generally" meet the test is not addressed. An example concludes that extraordinary personal services are not provided where the value of the services (measured by the cost of performing them) exceeds 50 percent of the amount charged for the use of the property.

SPECIAL CASES OF NONRENTAL RENTALS

The regulations provide three special cases in which the rental of property will not be treated as a "rental activity."

1. Property Held for Investment. Rental of property during a taxable year is treated as incidental to holding the property for investment (and therefore not a rental activity) if the principal purpose for holding the property during the year is to realize gain from appreciation and the gross rental income is less than two percent of the lesser of the adjusted basis or the fair market value of the property. The determination of whether the taxpayer's principal purpose is to realize gain from appreciation is made without regard to whether it is expected that such gain will be realized from the sale or exchange of the property in its current state of development. The most common situation that may be expected to come within this exception is the holding for investment of raw land that is subject to a grazing or hunting lease.

2. Property Used in a Trade or Business. Rental of property during a taxable year is treated as incidental to use of the property in a trade or business (and therefore, not a rental activity) if the property is "predominantly used" in the trade or business during the taxable year or during at least two of the five immediately preceding taxable years and the gross rental income from the property is less than two percent of the lesser of the unadjusted basis or the fair market value of such property. The regulations give no guidance as to what constitutes "predominant use"; presumably, use in the trade or business for more than half of the total time used will qualify.

3. Property Held for Sale to Customers. If property is sold during the taxable year and at the time of sale the property is held primarily for sale to customers in the ordinary course of a trade or business any rental of the property during the year of sale is treated as incidental to the activity of dealing in the property (and therefore, not as a rental activity). As discussed below, the interaction of this rule with the rules relating to characterization of gain on the disposition of property may have consequences that are unexpected by the taxpayer and unintended by the government.

THE TAX TREATMENT OF GAIN FROM THE DISPOSITION OF REAL ESTATE

1. The General Rule. The regulations provide that gain recognized upon the sale of property used in a passive activity in the year of sale is generally treated as passive income, regardless of whether the gain is recognized in the year of sale or subsequently under installment method. Thus a disposition of real estate that is used in a rental activity in the year of sale will generally give rise to passive income. Any material portion of a property (e.g. a building) that is used in a different activity from the balance of the property at any time prior to the sale is treated as a separate property, and the amount realized on the sale and the basis of the property sold must be allocated among the deemed separate properties in a reasonable manner. For example, assume a taxpayer sells a ten story building part of which was used in an active trade and the remainder of which was leased to others at all times prior to sale. The building is treated as two separate properties, therefor the amount of capital gains realized and the adjusted basis must be allocated accordingly.

2. Pre-1987 Installment Sales. The Internal Revenue Service took the position that the gain recognized in 1987 and later years from pre-1987 installment sales was never passive income, even though the property sold was clearly used in a passive activity. This position seems to be in conflict with the general rule that the nature of the activity in the year of disposition determines whether the gain from disposition of an asset is passive income or otherwise. Additional regulations limit the extent to which active income can be transformed into passive income through the planning and timing of different activities.

The Technical Corrections Act now before Congress would classify this income as passive. If the property was used in more than one type of activity (both active and passive), then any gain realized through disposition must be allocated between the activities on any basis that reasonably reflects the use of the property during the preceding twelve months. Another rule applies if the assets is "predominately used" in a particular activity and its fair market value does not exceed the lesser of $10,000 or ten percent of the value of all the properties used in that activity.

3. Substantially Appreciated Property. If the fair market value of property sold exceeds 120 percent of its adjusted basis at the time of sale, any gain on the sale that would otherwise be treated as passive will be treated as

nonpassive. This provision holds unless the property was used in a passive activity for either 20 percent of the period held by the taxpayer or the entire 24-month period ending on the date of sale.

THE RULES IN CONCERT

The interaction of the general rule regarding characterization of gain on sale and the rule regarding rental incidental to holding property for sale as a dealer may work at cross purposes with unfortunate (and possibly unintended) results. For example, assume that a taxpayer who owns an apartment building wishes to convert the building to condominium units and sell off the units. In previous years, the taxpayer might have sold the building to a condominium converter in order to avoid dealer status and realize any gain on sale as capital gain rather than ordinary income. With the elimination of the preferential treatment of capital gains, under current law the taxpayer may be more inclined to convert the building himself. If he does so, he almost certainly will be a dealer, and the rule for rental incidental to holding property primarily for sale to customers in the ordinary course of business will apply.

Under the incidental rental rule, the activity will not be a rental activity in the year the units are sold, and the allocation rule for property used in multiple activities during the 12 months preceding sale will therefore apply. If the taxpayer materially participates in the dealing activity, the portion of the gain on sale of the units that the allocation rule treats as allocable to the dealing activity will be active; the balance of the gain will be allocable to the rental activity and will be passive. Similarly, if the taxpayer does not materially participate but does "significantly participate" in the dealing activity, the portion of the gain that the allocation rule treats as allocable to the dealing activity will be subject to recharacterization as nonpassive. Because the allocation rule looks to the use of the property in the 12 months preceding sale, and because the incidental rental rule treats the activity as nonrental from the beginning of the taxable year than if they are sold near the end of the year. Accordingly, the well-advised owner/converter will conduct the sales effort in the fall but postpone closing on sales of units until the following January, thereby minimizing the amount of gain that may be characterized as active.

Moreover, in determining whether an individual materially or significantly participates in an activity, the regulations generally look to the total number of hours of participation in the activity during the taxable year, and do not prorate for participation in activities for less than a full tax year. Thus, if closing on sales of the units occurs early enough in January, it will be impossible for the taxpayer to meet the hourly thresholds for material or significant participation, and even the small amount of gain allocable to the dealing activity will be passive.

THE DEFINITION OF ACTIVITY

Many important issues await clarification in future regulations due to be issued before June 1, 1988, including the definition of "activity." This definition is crucial for at least four separate purposes under the regulation. First, the determination of whether a taxpayer materially participates in an activity can only be made if it is known what "the activity" is. Second, any previously suspended passive losses are deductible when the taxpayer disposes of his entire interest in "the activity." Third, the scope of the activity must be known in order to determine whether the gross income from the conduct of "the activity" is principally for the use of tangible property, and thus whether the activity is a "rental activity." Fourth, the definition of activity is central in determining whether the taxpayer owns an interest in a "pre-enactment activity" eligible for phase-in relief. Treasury Department officials have informally indicated that they are considering a broad definition for purposes of the material participation test, but are concerned that a broad definition may be too harsh for purposes of the disposition rules. It is possible that the regulations will adopt different definitions of "activity" for different purposes.

OTHER ISSUES

Beyond the issuance of the rules defining "activity" and clarifying other issues, the regulatory agenda is unclear. Many other significant areas remain to be addressed, including the treatment of dispositions under section 469, the rules for "active participation" real estate eligible for the $25,000 offset, the treatment of trusts and estates and publicly traded partnerships subject to these rules. Moreover, the preamble to the regulations already issued indicates that the IRS intends to monitor closely taxpayer efforts to structure passive income generators, and will prescribe additional anti-PIG rules as needed. Plainly, there is plenty to keep government lawyers and tax practitioners alike busy for years to come. Advocates on both sides of these issues will be occupied with understanding the new regulations and corrections to the tax laws for many years.

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